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SUBJECT: CAMBODIA'S BOOMING ECONOMY FUELS DEVELOPMENT, BUT  
CAN THE MOMENTUM BE SUSTAINED?

11. (SBU) Summary: During meetings with the Deputy Secretary of State September 14 and 16, a group of economic experts and development partners highlighted the dynamic economic growth taking place in Cambodia. Political stability has made possible double digit economic growth. However, Cambodia faces increasing challenges to maintaining this strong momentum in the future. Corruption, inflation, and high energy costs threaten Cambodia's ability to sustain the breakneck speed of development. Government efforts to address these concerns and increased diversification into the agricultural sector could have significant consequences for sustained economic growth and poverty alleviation. End Summary.

#### A Booming Economy

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12. (U) A decade of relative political stability in Cambodia has helped to fuel an average of 11 percent economic growth for the past five years, which is among the highest growth rates in the world, and remarkable achievement for a small country recovering from decades of turmoil and devastation. Cambodia's strong economic performance has largely been driven by expansion in the garment and tourism sectors. H.E. Hang Choun Naron, Secretary General of the Supreme Economic Council, Ministry of Economic and Finance, briefed the Deputy Secretary on improvements to the legal and regulatory framework and the robust growth in the financial sector. The government's liberal investment regime, among one of the most investor-friendly in the world, attracted USD 876 million in foreign direct investment in 2007. U.S. investors are increasingly taking note of the emerging opportunities, with Dupont, GE, and Microsoft recently establishing a presence in Cambodia. While this rapid rate of growth has contributed to a reduction in poverty levels, from 35 percent to 31 percent over the past three years, the dynamic growth brings with it new challenges and several factors threaten to impede further economic expansion.

#### Costs of Corruption

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13. (SBU) Despite the emerging opportunities attendant with the dynamic growth, weak rule of law continues to deter some would-be investors from entering the Cambodian market. U.S. and domestic businesses alike expressed their concerns about the lack of a fair and impartial judicial system to guarantee a fair dispute resolution process. Additionally, the lack of transparency and predictability in administrative procedures, such as registration, licensing, and permits, can increase the cost of doing business. (Note: Some recent investment agreements, such as one with Japan, provide for third party, international investment dispute resolution, although these mechanisms have yet to be tested in domestic courts. End Note.)

14. (SBU) However, Brett Sciaroni, President of the American-Cambodian Business Council, told the Deputy Secretary that the Cambodian government is the most open and accessible government in the region. He explained that the government's willingness to promote trade and investment allows most issues to be favorably resolved within the government before ever needing to seek judicial redress. U.S. businesses present in Cambodia are encouraging about their positive experiences and the government's strong support for foreign investment and trade facilitation, despite the weak rule of law.

#### High Costs of Energy

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15. (SBU) In addition to concerns about the lack of adequate legal protections for investments, the high cost of energy in Cambodia inhibits greater economic expansion. The group of economic experts explained to the Deputy Secretary that underinvestment in energy infrastructure coupled with skyrocketing demand to fuel the economic boom has resulted in a 100 kilowatt per hour shortfall in supply, pushing up the costs of energy in Cambodia to among the highest in the world, and up to three times the cost in neighboring Vietnam.

Eighty percent of Cambodia's energy supply is powered by diesel generators. The economic experts agreed that Cambodia's economic growth has been hampered by the high price of energy, with some estimating that the growth rate would double if energy costs are reduced. Sciaroni described Cambodia's efforts thus far to build its energy sector as insufficient to the task of meeting the ever-growing demand

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for power. However, Naron explained that Cambodia plans to import power from neighboring Thailand, Vietnam, and Laos, develop a transmission grid for distribution, and invest in a new coal-powered plant, and several hydropower projects. As a result, he expects Cambodia to be able to reduce the price per kilowatt hour down to 11 cents in 2011 from the current 17 to 20 cents.

#### Rising Prices Taking a Toll

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16. (SBU) Cambodia's high inflation rate, estimated at over twenty percent for 2008, poses additional challenges to the sustainability of the recent economic growth. High global fuel and food prices are driving up costs in Cambodia. According to ADB Country Director Arjun Goswami, the price of rice has doubled since last year and meat prices are up thirty to sixty percent. Van Sou Ieng, Executive Director of the Garment Manufacturers Association of Cambodia, explained that the rising cost of inputs, the vast majority of which are imported, coupled with a shortage of skilled labor which is driving up wage prices, are cutting into already thin profit margins in the garment sector. Vong predicted that without duty free access to the U.S. market, garment exports from Cambodia will fall thirty-five percent in 2009. IMF's Resident Representative John Nelmes warned that rising input and labor costs, combined with accelerated FDI unchecked by fiscal restraint, risk entrenched inflation. The gathered experts told the Deputy Secretary that Cambodia needs to further tighten its monetary and fiscal policy to check inflation, a goal many thought was achievable.

17. (SBU) The Cambodian government recently took strong measures to curb inflation which are applauded by the experts. These measures include a doubling of reserve requirements in July and the June limitation on the amount of loans to the real estate sector. Despite these efforts, excessive liquidity in the market is compounding the inflationary pressures, according to Nelmes. Cambodia's banking sector is growing rapidly, with credit lending up one hundred percent year on year. Nelmes emphasized that the National Bank of Cambodia lacks the capacity to adequately

monitor and regulate this booming sector. (Note: In other meetings, Nelmes has noted a strong suit of the government to effectively tamp down inflation has been its ability to exercise fiscal restraint. End Note.) Cambodia needs a sound and well-regulated banking system for sustained growth. (Note: A representative from the U.S. Department of Treasury's Office of Technical Assistance is currently conducting an assessment of Cambodia's banking and financial sectors to identify potential areas for technical assistance. End Note.)

#### Expansion in Agriculture Key for Sustained Growth

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¶8. (SBU) The economy is expected to grow by seven percent in 2008, down from 10.2 percent in 2007. Inflation and the slowing of the U.S. economy, with reduced demand for garment exports, are tempering the dynamic economic performance from previous years. While seven percent is still an impressive rate, Nelmes stressed that a difference of a mere three percent in GDP growth over the long term is the difference in graduating to middle income status in ten versus twenty years. The high inflation also threatens to undermine some poverty alleviation gains.

¶9. (SBU) To date, Cambodia's economic growth has been overly dependent on expansion in the garment and tourism sectors. ADB's Goswami stressed that the agriculture sector has huge and as-of-yet untapped potential for economic growth. With eighty to eighty-five percent of the working population engaged in agriculture, Goswami argued that rural economic development is key not only to continued robust economic growth but also to poverty alleviation.

¶10. (SBU) During a September 14 meeting with the Deputy Secretary, representatives from several foreign aid-funded projects working in Siem Reap province to promote private sector-led development acknowledged that the last decade has seen considerable progress, but noted an array of continued challenges to rural economic growth for the 8 to 9 million people who earn their livelihood from farming. Creating opportunities for both formal and informal dialogue has resulted in marked progress in communication and cooperation between public and private sectors. In contrast to neighboring Vietnam, however, growth proceeds at a slower

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pace and continues to be impeded by official corruption, lack of credit, and poor infrastructure.

¶11. (SBU) The representatives noted that the government and private sector have each undergone significant improvement in the past decade, but there is still much yet to be accomplished. Cambodia is poised on the brink of significant changes in agricultural production. Still largely driven by human-and animal-power, the shift to mechanization -- if properly managed -- could revolutionize agricultural production capacity, thereby serving as a true engine of economic growth and development for the country.

Comment  
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¶12. (SBU) Cambodia's strong economic performance is currently facing some challenging head winds. Inflation in particular threatens to impede further growth and undermine recent poverty alleviation gains. However, the Cambodian government's acknowledgment of these challenges and its efforts to address these concerns are encouraging for the economy's ability to maintain the high levels of growth achieved over the past decade.

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